



STATE OF CALIFORNIA  
**FRANCHISE TAX BOARD**  
PO Box 1468  
Sacramento, CA 95812-1468

KATHLEEN CONNELL  
Chair

JOHN CHIANG  
Member

B. TIMOTHY GAGE  
Member

## ***FTB Response to Public Suggestions on Best Audit Practices January 2002***

The Franchise Tax Board's *Vision of Success* provides that "We view our relationship with taxpayers as a partnership in which FTB staff and taxpayers work together to resolve tax problems at the earliest point possible." Throughout the audit process, we believe that open lines of communication and the establishment of a partnership relationship between the auditor and taxpayer is key to conducting an effective and efficient audit resulting in a less burdensome, less costly, and less intrusive audit process. We continue to study our audit procedures for ways to improve. Suggestions received at the Townhall Meetings were greatly appreciated and helped focus our efforts on areas where we were doing well, as well as areas where we could do better. The remainder of this document discusses our commitment to the continuation or adoption of audit practices based on suggestions received.

### **General Information**

Audits are to be conducted in accordance with the Franchise Tax Board Mission Statement and the Statement of Principles of Tax Administration. Accordingly, at the beginning of each audit, staff will provide these statements to a taxpayer or direct a taxpayer to our website for reference to these statements. Audits are to be conducted in a timely manner utilizing a fair and impartial approach that correctly applies the tax laws as enacted by the Legislature in a reasonable, practical manner.

It is our goal to complete audits within the shorter period of two years from the date of contact, or within the controlling statute of limitations period, thus minimizing the use of waivers. Typically, we will not open an audit within six months of the expiration of the normal statutes of limitations; however, facts and circumstances will control this determination.

In accordance with Revenue and Taxation Code Section 21008, in no circumstance is an auditor evaluated based on the amount of revenue generated because of an audit.

### **Shortening the Audit Process**

Audits typically cover a one or two year tax period and are limited to material issues. Before contacting the taxpayer, audit staff utilizes information databases to gain an understanding of the taxpayer's business industry and audit issues to minimize the taxpayer's time spent discussing these elements. During the course of a complex audit, a taxpayer can expect an opening and closing conference, as well as progress meetings as appropriate to expedite the audit process. Supervisors generally participate in all audits in some capacity, with the complexity of the case typically influencing the extent of the supervisor involvement in the audit. Initial contacts with the taxpayer will now include a reference to the auditor's supervisor and manager's name, and their telephone numbers. In the event a taxpayer believes more supervisor participation is necessary, the taxpayer may request additional involvement.

Currently, statutory authority does not exist for audit staff to settle tax matters, or for audit staff to enter into closing agreements except in rare and unusual circumstances.

We are pursuing the use of Email as an effective means of communication during the audit. We are working to ensure that appropriate mechanisms are in place to guarantee information security before implementation.

### **Opening Conference**

Opening conferences will be held on complex audit cases as a means to establish good communication between the auditor and taxpayer. Issues discussed will vary, but generally address the potential audit issues, information identified and relied upon as relevant information during the scoping process, materiality aspects, information requests and the best way to exchange information, sampling efforts, and the projected milestones and timeframes of the audit.

### **Materiality**

Materiality is a critical factor in all of our audits and will be considered throughout the audit process. The materiality level can change as the facts and circumstances of the audit change. For potential deficiency assessments, materiality is determined by considering the FTB cost related to addressing the issue to the potential tax adjustment. Materiality is not a factor considered once a refund issue has been identified during an audit and the taxpayer has provided relevant information supporting that refund. The auditor will address any questions regarding the materiality of an issue at any time during the audit.

Materiality considerations do not consider the taxpayer's costs in deciding whether the issue will be examined. However, once a material issue is identified for audit, the taxpayer's costs will be considered when requesting information and the use of alternative documentation, and when determining the most effective way to conduct an audit.

### **Information Document Requests**

Information Document Requests (IDRs) should be focused on the relevant facts necessary to address the audit issues. IDRs will either focus on an issue, or on a specific piece of information related to an issue, and in many situations, discussion with the taxpayer before the issuance of the IDR may be helpful and is encouraged. The auditor will address any questions regarding the relevance of information requested, or the use of alternative documentation.

### **Audit Issue Presentation Sheets**

On complex audit cases, audit staff will issue Audit Issue Presentation Sheets (AIPS) to the taxpayer at the time the analysis related to the issue has been completed. If one is not provided, the taxpayer may request one. AIPS will address the audit issue, facts relied upon, relevant law or authority, and tentative conclusion based on the facts and law, and will incorporate any mathematical calculations necessary to support or present the analysis.

Upon issuance of the AIPS, taxpayers will be given an opportunity to clarify facts and provide any rebuttal arguments. FTB staff will address any additional facts or law raised in the taxpayer's review of the AIPS. The taxpayer and auditor are encouraged to reach agreement on the facts related to the audit issue or describe what facts are still not agreed to, even if there is disagreement as to the application of law. Agreement with respect to the facts does not jeopardize any rights the taxpayer has to protest or appeal the audit determination.

## **Timeframes**

Normally response times to IDRs, AIPS, or other similar correspondence is 30 days from date of delivery. Auditors are expected to adhere to comparable timeframes. Extensions to response times should be discussed between the taxpayer and auditor and decided based on the applicable facts and circumstances.

Average response times for audit staff regarding information received from a taxpayer is approximately 30 days from the date of receipt.

## **Closing the Audit**

At the conclusion of a complex audit, audit staff will issue a closing letter and proposed tax computation schedules summarizing the audit adjustment(s). If one is not provided, the taxpayer may request one. Upon issuance of the closing letter, taxpayers will be given an opportunity to clarify facts and provide any rebuttal arguments. FTB staff will address any additional facts or law raised in the taxpayer's review of the closing letter. All parties are encouraged to agree to the facts related to the audit issue(s) or specifically identify the areas of disagreement. Any agreement to the facts does not jeopardize any rights the taxpayer has to protest or appeal the audit determination. In addition, on complex audit cases closing conferences may be beneficial to concluding the audit and should be conducted accordingly, or as requested.

We have implemented a procedure providing for a post audit survey. During the months of May and November, we send a post audit survey to taxpayers and representatives who recently had audits closed. The survey focuses on what we have done well, as well as what we could do better. The survey pertains to various aspects of the audit relating to communication, the information exchange process, timeliness, professionalism and technical ability of the auditor and other similar areas. We anticipate that survey results will be posted on our website during the first quarter of 2002, and updated after subsequent surveys.

## **Review**

Review staff and technical specialists may become involved in the audit at the request of the auditor. Upon conclusion of the audit, review staff will review the proposed audit adjustments for technical correctness and consistent application of audit standards. The auditor will discuss any changes made during the review process with the taxpayer as necessary.

## **Miscellaneous Issues Related to the Audit Process**

- **List of Settlement or Litigation Issues** – Most issues can be a matter for settlement based on the relevant hazards and/or costs of litigation. Similarly, any issue can be a matter for litigation depending on the facts and circumstances. The Franchise Tax Board maintains a litigation roster on its website containing information related to issues currently under litigation.
- **FTB website – Legal References** – Legal references on our website include rulings, FTB Notices, and proposed regulations, all of which have general application to taxpayers. Briefs related to appeals or litigation matters are not included on the Franchise Tax Board website generally because of their limited application to any taxpayer other than the one involved in the appeal or litigation.

- **Legal Involvement in Audits** – The auditor's responsibility is to work with the taxpayer to gather facts relevant to the issue under audit and apply the law based on those facts. In all situations, efforts are made to resolve tax matters at the lowest level and ensure objectivity throughout the tax resolution process. In unique situations, Legal staff may become involved in the audit process on a limited basis to address legal interpretation issues raised by the auditor, taxpayer or tax representative.
- **Resolution of Disputes Related to the Conduct of the Audit** – In the event a dispute occurs during the audit process regarding the conduct of the audit, the taxpayer is encouraged to discuss the issue with the auditor, or their supervisor to resolve. To accommodate this process, initial contacts with the taxpayer will now include the name of the auditor's supervisor and manager, and their telephone numbers. If the dispute is not resolved with the assistance of the auditor and supervisor, the Program Manager and Bureau Director are available to facilitate resolution of the dispute. In addition, under the provisions of Revenue and Taxation Code Section 21004, the taxpayer has the right to contact the Taxpayer Advocate Officer. Under no circumstances will any retaliatory actions result against the taxpayer.
- **Penalty Assessment** – The accuracy related penalty and the failure to furnish information penalties are tools used within the audit process to ensure compliance with the tax laws, or as a mechanism to discourage continued delays in response to information document requests issued to substantiate a return position. Effective January 1, 2002, when either of these penalties are assessed, the auditor's immediate supervisor's authorization is generally required.

The above reflects our commitment to work with taxpayers to conduct an audit utilizing the most effective and efficient audit procedures. Throughout the audit process, we believe that open lines of communication and the establishment of a partnership relationship between the auditor and taxpayer is key to conducting an effective and efficient audit. We are continually updating our manuals and training materials to reflect these best audit practices.

We continue to solicit the input of the taxpayer and practitioner community for ways to improve the FTB audit process. Written comments and suggestions can be provided through post-audit surveys or can be submitted on-line via the respective audit manual comment pages. We will also be holding subsequent townhall meetings on best audit practices to help continue our focus on areas where we are doing well, as well as areas where we could do better.